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August 25, 2008

Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

RE: 12 CFR Part 723 Member Business Loans; 73 Federal Register 35977, June 25, 2008

Dear Secretary Rupp:

As Director of the Washington State Division of Credit Unions, I appreciate the opportunity to comment on the advanced notice of proposed rule-making (ANPR) for Part 723 Rules and Regulations relating to Member Business Lending (MBL) in credit unions. In Washington State, we examine MBL programs to ensure credit unions maintain the same safety and soundness practices as banks of similar size and complexity. Many Washington State credit unions have a history of successfully making MBLs in order to help their members. We believe those credit unions, that have commercial lending expertise, should be authorized to take advantage of the opportunities MBLs present.

However, we identified areas for concern in the current regulatory framework, which if strengthened, could enable credit unions to improve their risk mitigation in MBLs.

Please consider the following detailed comments.

Loan-to-Value Ratio Requirements
The current regulation has a maximum 75% LTV for construction and development (C&D) loans (§723.3(b)).

We would recommend no change to the C&D maximum LTV at this time. C&D is one of the riskiest MBL types, and the LTV should remain conservative. Because the regulation does not require “cash” equity, the equity contribution by the borrower can be recognized through an appraisal value higher than the cost of the project. If NCUA raises the maximum C&D LTV from 75%, we recommend that "cash" equity also be required. In addition, we believe the waiver application process works well for credit unions that demonstrate prudent risk mitigation for LTVs higher than 75%.

Experience Requirements

General

12 C.F.R. 723.5 requires the use of an individual with at least two years experience in the type of lending the credit union proposes to do. Credit unions do not have to hire staff, but can use a credit union subsidiary organization (CUSO) or outside party. However, we agree that the "actual decision to grant a loan must reside with the credit union."

Credit unions with limited MBL experience should embark in member business lending in a limited manner and build expertise gradually over time as the program grows. Examiners become concerned if a credit union builds a MBL program of material size in a rapid manner. The Washington State Division of Credit Unions has addressed many of its concerns regarding MBL expansion in the DCU Bulletin No. B-06-01. A copy of the Bulletin is attached.

Two Years of Experience is Inadequate

We recommend NCUA change the experience requirement from the number of years to "expertise commensurate" with the type of MBLs the credit union is seeking. Regulators do and will require more than two years experience for complex or larger commercial loans. The "two years" experience requirement does not provide enough guidance to credit unions as to realistic expectations for MBL officers.

While we do find some credit unions with significant internal MBL expertise, we still have concerns. We found a credit union that did not understand how to evaluate the experience level of persons with business lending backgrounds. Examiners sometimes find individuals touted as having "a lot of experience" when in reality their actual experience was as a branch manager at a bank or another ancillary MLB position. For example, a person experienced in marketing commercial lending to the business community would not be sufficient to meet our requirement for a "two year qualified" business lending expert. Examiners look for expertise in the following areas:

- underwriting, evaluating and recommending the loan,
- understanding which, when, or why legal documents are necessary to protect the credit union,
- monitoring the MBL after it is put on the books,
- classifying the MBL, and
- evaluating the appropriateness of extensions or other workout concessions.

We recommend the rule be expanded to provide specific comments about the need for experience in the above areas. The "two years of experience" criterion should be augmented by an assessment of the meaning and relevance of the experience standards, as set forth in NCUA's legal letter 08-0128, with the express stipulation that having a credit union employee "learning as they go" is inadequate to fulfill the experience requirement. http://www.ncua.gov/RegulationsOpinionsLaws/opinion_letters/2008/08-0128.pdf .

Internal vs. External Expertise

We recommend NCUA incorporate language from its legal letter 08-0302, regarding conflict of interest with outside parties into the Part 723.
http://www.ncua.gov/RegulationsOpinionsLaws/opinion_letters/2008/08-0302.pdf

The regulation should not give equal weight to internal versus external expertise. We found a credit union made the decision to lend, based simply on the credit memo produced by a credit union subsidiary organization (CUSO). The credit union did not have sufficient expertise to ask probing questions about the MBL (credit). In addition, commercial credits often represent a long-term relationship between the lender and borrower involving years of monitoring, discussions, anticipating needs or conditions, and adjustments to the relationship. Lack of internal expertise may lead a credit union to treat MBLs as "investments" and they may not understand how to do monitoring or follow-up analysis. In general, external expertise does not work as well as an internal commercial lending experts for a variety of reasons as discussed in various letters to credit unions about due diligence and third parties.

Loan Participations & CUSOs

We suggest the current waiver application requirements are adequate and do not need to be expanded. We have no inherent objection to credit unions investing in commercial credits through participations or the use of CUSOs or other third parties. The credit union, however, should understand they do not transfer the responsibility for risk analysis to the CUSO or another financial institution. Each participating credit union is responsible for arriving at its own credit decision based on adequate credit information. Inability to obtain sufficient data from the CUSO to properly evaluate the credit should mandate that the credit participation be denied.

Need for Broad Standards for MBL Program Structure

The current regulation only indirectly addresses the broad program elements that should be in place for a MBL program of any material size. Before a credit union is approved for a waiver or expanded MBL authority, we recommend NCUA require information on how the MBL program will affect its operations in the following:

- internal controls
- management reporting systems
- internal audit
- loan documentation systems
- credit underwriting
- asset quality evaluations
- loan pricing evaluations

Summary
In summary, we appreciate NCUA reviewing the rule on MBLs.

Thank you for affording us the opportunity to comment on the ANPR. We hope you find our comments helpful in your deliberations regarding the issues discussed in it.

Sincerely,

Linda Jekel

Linda K. Jekel
Director of Credit Unions

Attachment: DCU Bulletin B-06-01

DCU BULLETIN

Division of Credit Unions
Washington State Department of Financial Institutions
Phone: (360) 902-8701 ***FAX: (360) 704-6901***

January 11, 2006 No. B-06-01

Safe & Sound Expansion of MBL Portfolios

The Division of Credit Unions (Division) worked to extend to Washington state chartered credit unions (WSCCUs) the flexibility they need to effectively provide members with the loans to develop their businesses and thereby strengthen the economy in Washington. WSCCUs must follow Chapter 208-460 WAC requirements for Member Business Lending (MBLs). This rule and the statutory requirements on the safe and sound operation of credit unions provide the authority to make MBLs within state chartered credit unions.

As of June 30, 2005, 43 of 79 WSCCUs had a MBL portfolio and 35 of the 43 WSCCUs held less than 5% of their assets in MBLs. In addition to various MBL portfolio sizes, the size of individual MBLs vary. The current rule provides for credit unions wishing to extend small business loans to members as well as credit unions wishing to make MBLs on a much larger scale. The Division recognizes there are credit unions at various places along the size continuum. The Division expects WSCCUs with larger MBL operations to demonstrate adequate sophisticated standards of operation to manage and mitigate the associated risks.

<u>Expertise</u>

WAC 208-460-040 requires the following: “The credit union must utilize the services of an individual with at least two years direct experience with the type of lending the credit union will be engaging in…” The rule continues “Credit unions do not have to hire staff to meet the requirements of this section; however, credit unions must ensure that the expertise is available.”

Credit unions need to be aware the two years requirement is a minimum. In most cases that level of experience does not allow the staff to understand the impact of the full business cycle on loans of various types. For this reason ten or more years experience is desirable. The Division expects close adherence to the requirement for experience in the specific loan types the Board has approved in the MBL policy. It should also be noted, the experience of a loan officer is of little benefit should more senior management fail to understand or implement recommendations suggested by that loan officer.

To ensure adequate expertise to manage the risks of business lending, some credit unions with a small MBL portfolio hire consultants or buy services from a credit union service organization with commercial lending experts. Generally, the Division finds this approach acceptable if the MBL portfolio is not a material percentage of assets and the consultant/purchased services are adequate to manage all MBL risks.

For the Division’s examination purposes, a “material amount” is defined as the lesser of $25 million or 5% of assets invested in MBLs. Once a credit union has reached a “material amount” of member business loans on the books, the Division expects to find credit union employees with the required expertise to manage a MBL portfolio. The Division examines the adequacy and completeness of ongoing evaluation of all aspects of managing the business loan portfolio. Generally, when the Division finds safety and soundness issues because the risks are not managed and mitigated according to industry standards for commercial lending, the common cause is a lack of adequate in-house expertise.

<u>Application for MBL authority above 12.25% of assets</u>
A few credit unions have applied for approval to make MBLs above the 12.25% of assets aggregate limit found in WAC 208-460-130 and -140. Before approving an application for expanded aggregate MBL authority, the Division examination must verify the credit union meets similar safety and

soundness practices of commercial lending by a bank of similar size. The Division examination follows the examination standards used by the FDIC. (see Appendix A).

Prior to applying for such expanded authority, the Division expects a credit union to engage a third party, qualified to assess the management of a commercial lending operations, to do a thorough review of all phases of its member business lending. The third party review should use standards found in the FDIC guidelines in Appendix A. In addition, the credit union's internal auditor and external audit should also identify areas for improvement. The credit union should adequately address any findings of the third party review and audit prior to application for expanded MBL authority. If the credit union internal audit function does not have extensive experience auditing member business loans, the Division expects the credit union to have a well qualified third party that understands the FDIC Standards perform an annual review of the business lending operation.

Upon receipt of an application for expanded aggregate MBL authority, the Division will schedule an on-site, limited scope examination. Typically, the examination team will be composed of a Division examiner, a National Credit Union Administration examiner, and a bank examiner. Upon the examination's conclusion that the credit union operation is as safe and strong as those of similar sized banks, the application may be approved. At a minimum, the on-site MBL examination will consider the various reports and program elements found in Appendix B. After approval of expanded MBL authority, all ongoing examinations will continue to use FDIC standards applicable for evaluating a commercial lending operation.

If you have questions about this Bulletin, please contact Mike Delimont at (360) 902-8753 or MDelimont@dfi.wa.gov.

APPENDIX A

FEDERAL DEPOSIT INSURANCE CORPORATION
12 CFR PART 364 - STANDARDS FOR SAFETY AND SOUNDNESS

Operational and Managerial Standards with application to MBLs

A. **Internal controls and information systems**. An institution should have internal controls and information systems that are appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for:

1. An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to established policies;
2. Effective risk assessment;
3. Timely and accurate financial, operational and regulatory reports;
4. Adequate procedures to safeguard and manage assets; and
5. Compliance with applicable laws and regulations.

B. **Internal audit system**. An institution should have an internal audit system that is appropriate to the size of the institution and the nature and scope of its activities and that provides for:

1. Adequate monitoring of the system of internal controls through an internal audit function. For an institution whose size, complexity or scope of operations does not warrant a full scale internal audit function, a system of independent reviews of key internal controls may be used;
2. Independence and objectivity (reporting to the supervisory committee);
3. Qualified persons;
4. Adequate testing and review of information systems;
5. Adequate documentation of tests and findings and any corrective actions;
6. Verification and review of management actions to address material weaknesses; and
7. Review by the institution's audit committee or board of directors of the effectiveness of the internal audit systems.

C. **Loan documentation**. An institution should establish and maintain loan documentation practices that:

1. Enable the institution to make an informed lending decision and to assess risk, as necessary, on an ongoing basis;
2. Identify the purpose of a loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner;
3. Ensure that any claim against a borrower is legally enforceable;
4. Demonstrate appropriate administration and monitoring of a loan; and
5. Take account of the size and complexity of a loan.

D. **Credit underwriting**. An institution should establish and maintain prudent credit underwriting practices that:

1. Are commensurate with the types of loans the institution will make and consider the terms and conditions under which they will be made;
2. Consider the nature of the markets in which loans will be made;
3. Provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;
4. Establish a system of independent, ongoing credit review and appropriate communication to management and to the board of directors;
5. Take adequate account of concentration of credit risk; and
6. Are appropriate to the size of the institution and the nature and scope of its activities.

E. & F. Not applicable to commercial lending

G. **Asset quality**. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should:

1. Conduct periodic asset quality reviews to identify problem assets;
2. Estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses;
3. Compare problem asset totals to capital;
4. Take appropriate corrective action to resolve problem assets;
5. Consider the size and potential risks of material asset concentrations; and
6. Provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk.

The FDIC, Division of Supervision Manual of Exam Policies, Section 3.1 on loans, is also a valuable resource.

APPENDIX B

APPLICATION REQUIREMENTS TO INCREASE MEMBER BUSINESS LOANS (MBLs) LIMITS under WAC 208-460-140

Provide the following information to the Division for our review to determine the prudent limit for your MBL portfolio and the plan for moving to that limit should it be approved.

A. A copy of your current member business loan policy (including officer lending limits, and most recent board approval date)
B. The requested limit sought for your MBL portfolio, with any other limitations you are proposing to the portfolio
C. An explanation of the need to raise the limit above the current limit
D. Documentation supporting your ability to manage the current MBL portfolio, including as a minimum:
   1. The history of loan losses, current loan delinquency, loan grading system, and Allowance for Loan & Lease Loss analysis applicable to MBLs
   2. Volume and cyclical or seasonal patterns
   3. Diversification by collateral type, include unsecured as a “type”
   4. Diversification by geographic location
   5. Concentration of credit to one borrower or group of associated borrowers in excess of 15% of reserves (excluding the Allowance for Loan Losses account)
   6. Underwriting standards and practices
   7. Types of loans grouped by purpose and collateral
   8. The qualifications of personnel responsible for approving, underwriting and administering MBLs (including collection department)
   9. An organization chart of the MBL department and copies of the resumes for all officers and employees in the MBL department,
   10. A description of the experience and training of credit union executive management (CEO, CFO, CLO & internal audit), and
   11. A description of the experience and training of supervisory committee members and directors in understanding and monitoring the risk of an MBL portfolio

E. If not included in the above, provide information on the following:

   1. The current percentage of MBLs to total loans and to net worth
   2. The annual percentage of MBLs to total loans over the last five years
   3. The number, amount, and list of MBLs with no personal guarantees
   4. The number and amount of unused MBL lines of credit (LOC), excluding car dealer flooring LOCs
   5. The number and amount of car dealer flooring lines of credit
   6. The number and amount of MBL applications in process
   7. The number and amount of MBL construction and development loans
   8. The number and amount of MBLs to uncompensated directors or committee members and their immediate family members

9. Copies of the most recent internal audit and Supervisory Committee/CPA audit as well as any 3rd party reviews relating to MBLs with the credit union response
10. A copy of your MBL's internal controls and collection procedures, if not included in A. above
11. What do you anticipate in annual MBL growth for the next 5 years as to type and percentage of MBLs. Briefly describe how plans for sale or purchase of MBLs fit within the business plan of the credit union
12. How do you monitor the economic condition and forecast of the geographic areas served by MBLs?
13. Provide a list all MBL participations purchased and sold over the past 5 years. Include borrower name, loan number, term, loan rate, fixed or variable rate, any fees or other compensation, and purchasing institution. Describe which participations are sold with recourse.
14. Briefly describe the process used to find, qualify and document a sale or purchase of MBL participations. Provide copies of template agreements used and copies of any comments about the agreements from your attorneys.